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Accounting Research BULLETINS

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No. 21

Renegotiation of War Contracts (Supplement)

THIS bulletin supplements Accounting Research Bulletin No. 15 issued in September, 1942, and deals further with the financial statements of contractors and subcontractors who are affected by the provisions of the War Profits Control Act (Section 403 of Public Law 528, 77th Congress, as amended).

SUMMARY STATEMENT

(1) Since renegotiation proceedings have now been conducted over a considerable period of time, it is to be expected that many companies, particularly those which have completed renegotiation proceedings for a prior year, will be in a position to make reasonable provision for renegotiation refunds in their current financial statements, in accordance with the long recognized accounting principle that provision should be made in financial statements for all liabilities that can be reasonably estimated.

(2) Where such provision is made, there should be disclosure in the financial statements, by footnote or otherwise, of the basis upon which it is made. It is recognized that by reason of changed conditions, a settlement made in the preceding year may not, in some cases, be indicative of the amount refundable in respect of the current year, and the provision made should take account of this possibility. If, however, the provision is materially less than the amount which would be indicated on the basis of a prior year's settlement, the reasons therefor and the approximate effect of the difference upon the net income were a refund required on the same basis for the current year, should be stated, except as hereinafter provided.

(3) Where a provision is not made, a statement to that effect should be set forth in a footnote, together with appropriate disclosure of the reasons therefor and of the company's renegotiation status. If a settlement has been effected for a prior year, such disclosure should, except as hereinafter provided, include a statement of the approximate effect upon the net income were a refund required on the same basis for the current year.

(4) The information required under paragraphs (2) and (3)

above in respect of the effect of applying the basis of a prior year's settlement to the current year, may be omitted if there is substantial reason to believe that misleading inferences might be drawn therefrom. In such cases, however, a statement should be made why the basis used for the prior year is not applicable to the current year.

(5) Provision for renegotiation refunds should be included in the balance-sheet as a current liability. In the income statement such provision should preferably be made as a deduction from sales, with the income and excess-profits tax and postwar refund computed accordingly. However, because of the interrelation between renegotiation refunds and income and excess-profits taxes, the provision may be set forth in the financial statements in conjunction with the provision for taxes, either as separate items or as a combined amount.

(6) If the renegotiation refund required to be paid for any year is different from the provision made therefor in the financial statements originally issued for such year, the difference should be included in the current income statement unless such inclusion would result in distortion, in which event the adjustment may be made through earned surplus. Where earned surplus is thus charged or credited the reported results of the preceding year should be appropriately revised. The committee believes that this can best be done by presenting a revised income statement for the prior year, either in conjunction with the current year's financial statements or otherwise, and it urges that this procedure be followed.

DISCUSSION

In September, 1942, this committee issued Accounting Research Bulletin No. 15, entitled "The Renegotiation of War Contracts." The summary statement of that bulletin reads as follows:

"In the financial statements of contractors or subcontractors who are subject to the provisions of the War Profits Control Act indication should be given of the possibility of renegotiation thereunder of government contracts or subcontracts. In some cases a reserve, shown as a deduction in the income account, may be desirable, but probably in most cases, particularly at the present stage, a footnote to the financial statements will accomplish the purpose of disclosure."

Prior to the issuance of that bulletin the committee, on several occasions, had stated in effect that it is plainly desirable to provide, by charges in the current income statement, properly classified, for all foreseeable costs and losses applicable against current revenues, *to the extent that they can be measured and allocated to fiscal periods*

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*with reasonable approximation.*¹ In applying this rule to the possibility of renegotiation refunds the committee felt that, under the then existing circumstances, provision through the medium of a reserve would not ordinarily be feasible and that fair disclosure seemed to be all that could be required in most cases. The committee indicated, however, that it proposed to consider the subject further at a later date.

Provision for Renegotiation Refunds

Since the issuance of Bulletin No. 15 many corporations have completed renegotiation proceedings; published and other data with respect to such proceedings are available to corporations and to accountants; and the developments in connection with such proceedings have in a measure reduced the area of uncertainty with respect to refunds. This is particularly true of corporations which have completed renegotiation proceedings for prior years or which have progressed in renegotiation discussions to a point where differences of opinion as to the total refund to be made are not likely to be great. The committee believes, therefore, that the circumstances now surrounding the matter of renegotiation are such that Accounting Research Bulletin No. 15 should be amplified and that in many cases the accounting treatment of possible renegotiation refunds should be based upon the established accounting principle that provision should be made in the financial statements for all liabilities, including reasonable estimates for liabilities accrued but not accurately determinable. Under this principle, provision should be made for possible renegotiation refunds wherever the amount of such refunds can be reasonably estimated.

In addition to such provision, disclosure should be made, by footnote or otherwise, of the basis used in determining the amount thereof, as for instance, the prior years' experience of the contractor or of similar contractors, renegotiation discussions relating to the current year, etc. Such disclosure is essential if stockholders or other interested parties are to be fairly informed as to the company's status under the renegotiation law. It is recognized that by reason of changed conditions the results of a prior year's settlement may not, in some cases, be indicative of the amount refundable in the current year and the provision made should take account of this possibility. Nevertheless, if the provision is made in an amount materially less than that which would be indicated if the basis of a prior year's settlement were applied to the current year, there should be included, except as hereinafter provided, a statement as to the approximate

¹ Accounting Research Bulletins Nos. 8 and 13.

effect of the difference upon the net income and the reasons for provision of the lesser amount. There is a presumption that refund will have to be made on a basis no more favorable than that applied in the preceding year; the statement should, therefore, indicate clearly why it is believed that the presumption does not apply.

The committee recognizes that there may be cases in which misleading inferences might be drawn from disclosure of the approximate effect upon net income of the difference between the provision made and the amount indicated on the basis of a prior year's settlement. The facts with respect to products, methods of manufacture, selling prices, volume, etc., may differ materially in the current year as compared with those of the prior year. In such cases, if there is substantial reason to believe that misleading inferences might be so drawn, disclosure of the effect of the difference on net income may be omitted.

Disclosure Where No Provision Is Made

It is recognized that there will be cases where reasonable provision for renegotiation refunds cannot be made. Such situations may exist where renegotiation proceedings for the current year or a preceding year have not been completed or where the basis of settlement for preceding years is believed not to be applicable to the current year. They may exist despite the fact that proceedings for a prior year resulted in a determination that no refund was required. If, however, for any reason, provision is not made, a statement as to the reason why no provision is made, together with appropriate disclosure of the pertinent facts with respect to the company's renegotiation status, should be incorporated in a footnote. In those cases where a settlement has been made in a preceding year, appropriate disclosure requires the inclusion of: (a) a statement of why such basis is not believed to be applicable and (b) a statement, except as hereinafter provided, of the approximate effect on the current net income were a refund required on the same basis for the current year. Even though it is not conceded that the basis of such settlement is applicable to the current year, disclosure as to the approximate effect of substantially similar treatment in the current year is ordinarily essential to a fair understanding of the company's renegotiation status.

As indicated above, there may be cases in which there is substantial reason to believe that misleading inferences might be drawn from disclosure of the effect on net income were a refund required on the basis of a prior year's settlement, in which event such information may be omitted. The committee feels, however, that any such omission must be justified by the facts, which should be clearly set forth.

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Financial Statement Presentation

Provision for renegotiation refunds should be included in the balance-sheet among the current liabilities.

With respect to the income statement, this committee has heretofore stated that profit is deemed to be realized when a sale in the ordinary course of business is effected, *unless the circumstances are such that the collection of the sales price is not reasonably assured.*² While renegotiation refunds are commonly referred to as involving a refund of "excessive profits," the provisions of the statute indicate that renegotiation involves an adjustment of the original contract or selling price. Since a provision for renegotiation refund indicates that the collection, or retention, of the selling price is not reasonably assured, the committee believes that the provision should preferably be shown in the income statement as a deduction from sales. Because of the interrelationship of renegotiation and income and excess-profits taxes, the provision for such taxes, including the postwar refund of excess-profits tax, should then be computed accordingly.

The amount refundable is, however, frequently a net amount, i.e., allowance is made for any income and excess-profits taxes which may have been paid or assessed thereon. As an alternative, therefore, the provision for refund may be shown as a charge in the income statement, separately from the provision for such taxes, or in combination therewith. The provision may be shown in the net amount refundable or in the amount of the price reduction with appropriate adjustment of the tax provision.

Renegotiation Refunds for Prior Years

A further question arises where a renegotiation refund applicable to a particular year is made in an amount materially different from the provision made in the financial statements originally issued for such year. The committee has heretofore indicated that it approves the tendency to discourage charges to earned surplus even though such charges involve the correction of estimates made in prior years.³ It suggests, therefore, that the difference between the provision made and the renegotiation refund should be shown as a separate item in the current income statement, unless such inclusion would result in a distortion of the current income, in which event the adjustment may be made through earned surplus. Where the adjustment is made through earned surplus, however, there should be appropriate disclosure of the effect of the adjustment on the prior year's net income.

² Accounting Research Bulletin No. 1.

³ Accounting Research Bulletins Nos. 8 and 13.

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The committee believes that this can best be done by presenting a revised income statement for the prior year, either in comparative form in conjunction with the current year's financial statements⁴ or otherwise, and it urges that this procedure be followed.

The statement entitled "Renegotiation of War Contracts (Supplement)" was adopted by the assenting votes of twenty members of the committee. One member, Mr. Towns, dissented.

Mr. Towns dissents as to those portions of the bulletin which imply that the results of renegotiation for a prior year provide a basis for the amount of a provision for renegotiation for a current period; he believes that a prior year's results do not constitute such a basis because (aside from other factors of uncertainty) they have been derived from the judgment of individuals, which may be different in a future decision, rather than from any reasonably definite and continuing formula.

NOTES

1. *Accounting Research Bulletins* represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee and the research department. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached. (See Report of Committee on Accounting Procedure to Council, dated September 18, 1939.)

2. Recommendations of the committee are not intended to be retroactive, nor applicable to immaterial items. (See Bulletin No. 1, page 3.)

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. (See Bulletin No. 1, page 3.)

⁴ See Accounting Research Bulletin No. 6.

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